



Key Points

- The world economy post the GFC: EM, debt-ridden developed economies and the ‘caterers’ to EM growth.
- Australia benefits greatly from its export mix and proximity to the Asian growth centres.
- Our forecasts have growth back to trend – but not for every sector.
- If mining grows as a share of the economy then other sectors must be squeezed. Sectors exposed to the currency and interest rates will be under pressure.
- The growing importance of commodities will make the Australian economy more volatile, with implications for fiscal and monetary policy. The global economy will also be more volatile given the stretched nature of sovereign balance sheets and the regulatory and market constraints on credit growth.
- This means we need to be prepared for downside shocks even when the outlook seems positive.
- Our relative success during the GFC helps explain the current hawkish stance of the RBA.





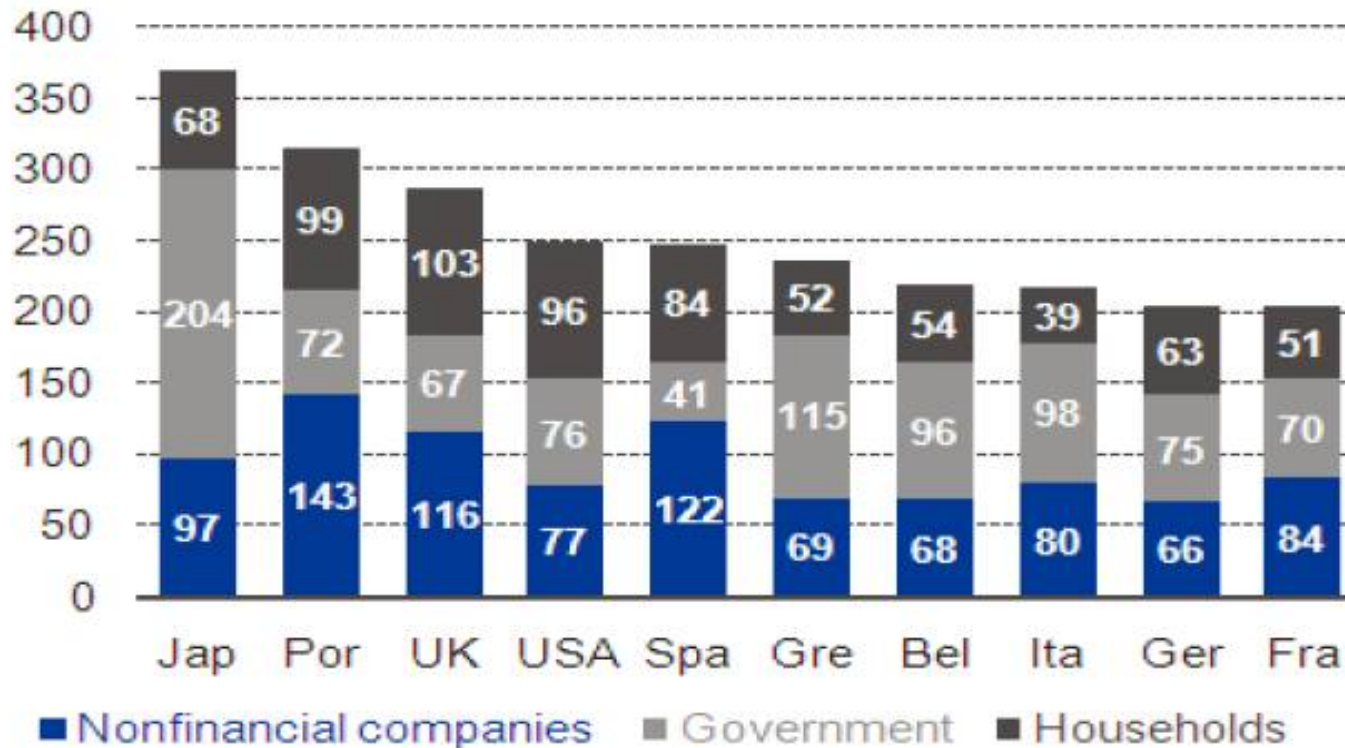
Some longer-term thoughts on the post-GFC economy



Debt will be a constraining factor on the developed world for many years to come

Debt of the non-financial sector

% GDP



Consolidated data, only UK data is non-consolidated
Most recent data, i.e. 2010: USA, Japan, 2009: UK, Germany, Portugal, Belgium, Greece, 2008: Spain, France, Italy

Source: Eurostat, Fed, BoJ

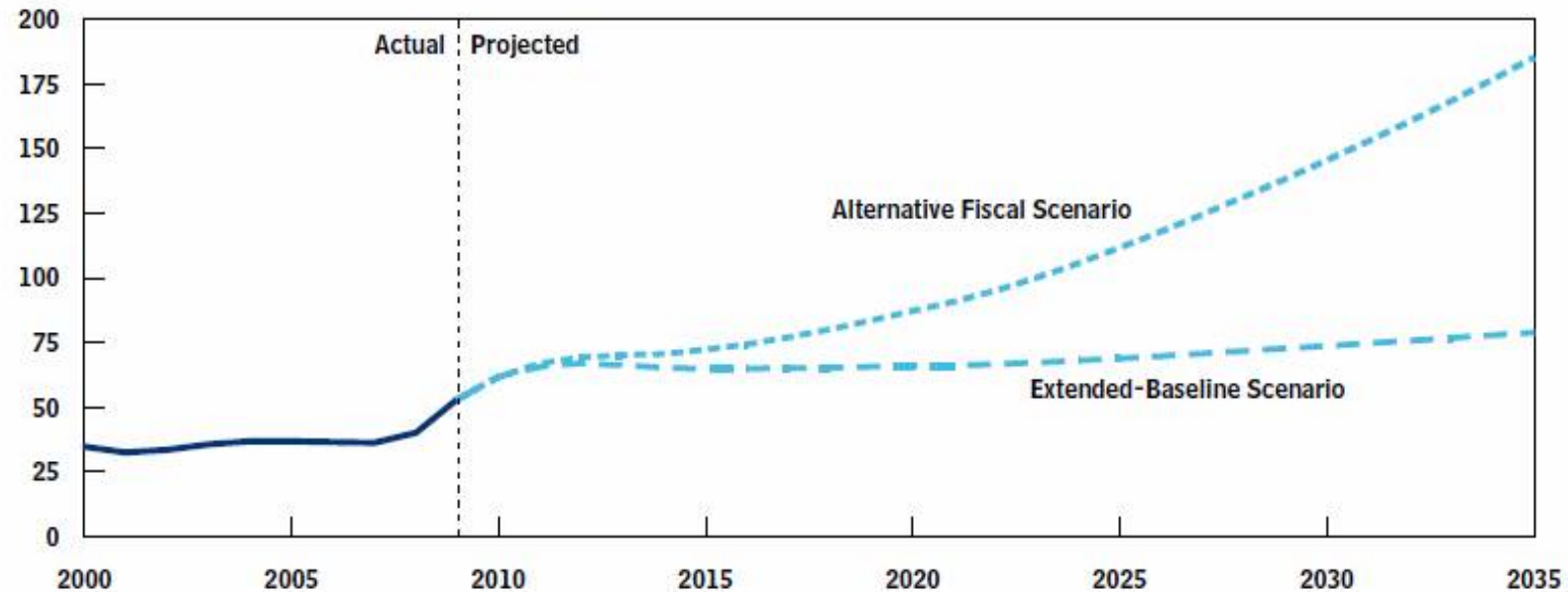


For instance, the fiscal challenge facing the US is enormous

Figure 1-2.

Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2020 (with adjustments for the recently enacted health care legislation) and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period. (For details, see Table 1-1 on page 3.)

Source: Congressional Budget Office

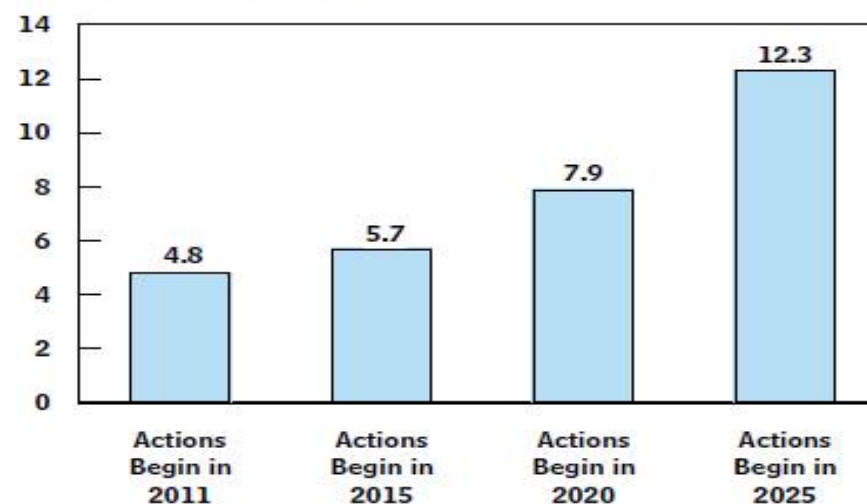
With massive changes to spending or taxes required



Figure 1-3.

Reductions in Primary Spending or Increases in Revenues in Various Years Needed to Close the 25-Year Fiscal Gap Under CBO's Alternative Fiscal Scenario

(Percentage of gross domestic product)



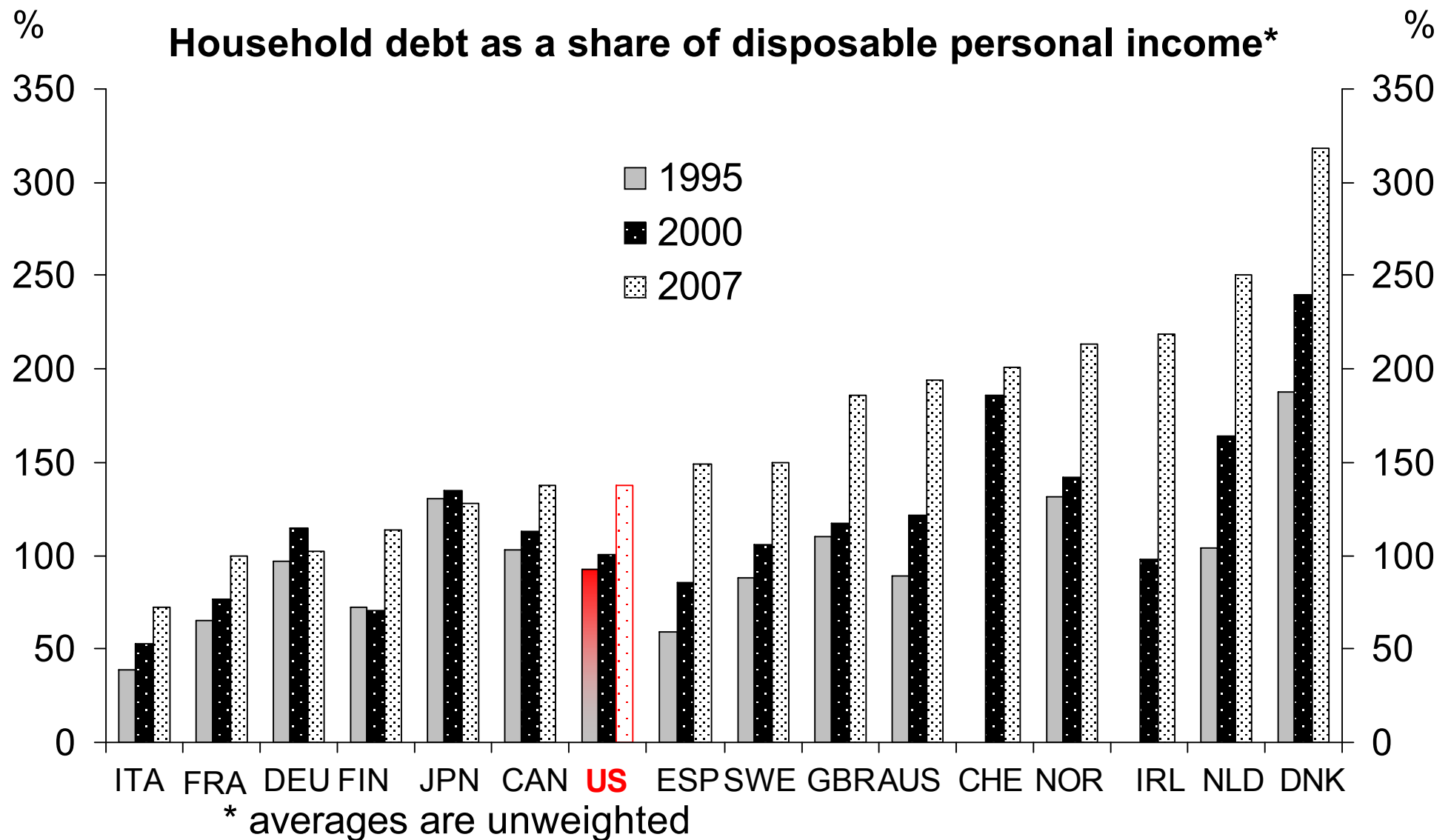
Source: Congressional Budget Office.

Notes: Primary spending refers to all spending other than interest payments on federal debt.

The fiscal gap is a measure of federal shortfalls over a given period. It represents the extent to which the government would need to immediately and permanently either raise tax revenues or cut spending—or do both, to some degree—to make the government's debt the same size (relative to gross domestic product) at the end of the period that it was at the beginning of 2010.

Source: Congressional Budget Office

US better placed when we look at household debt



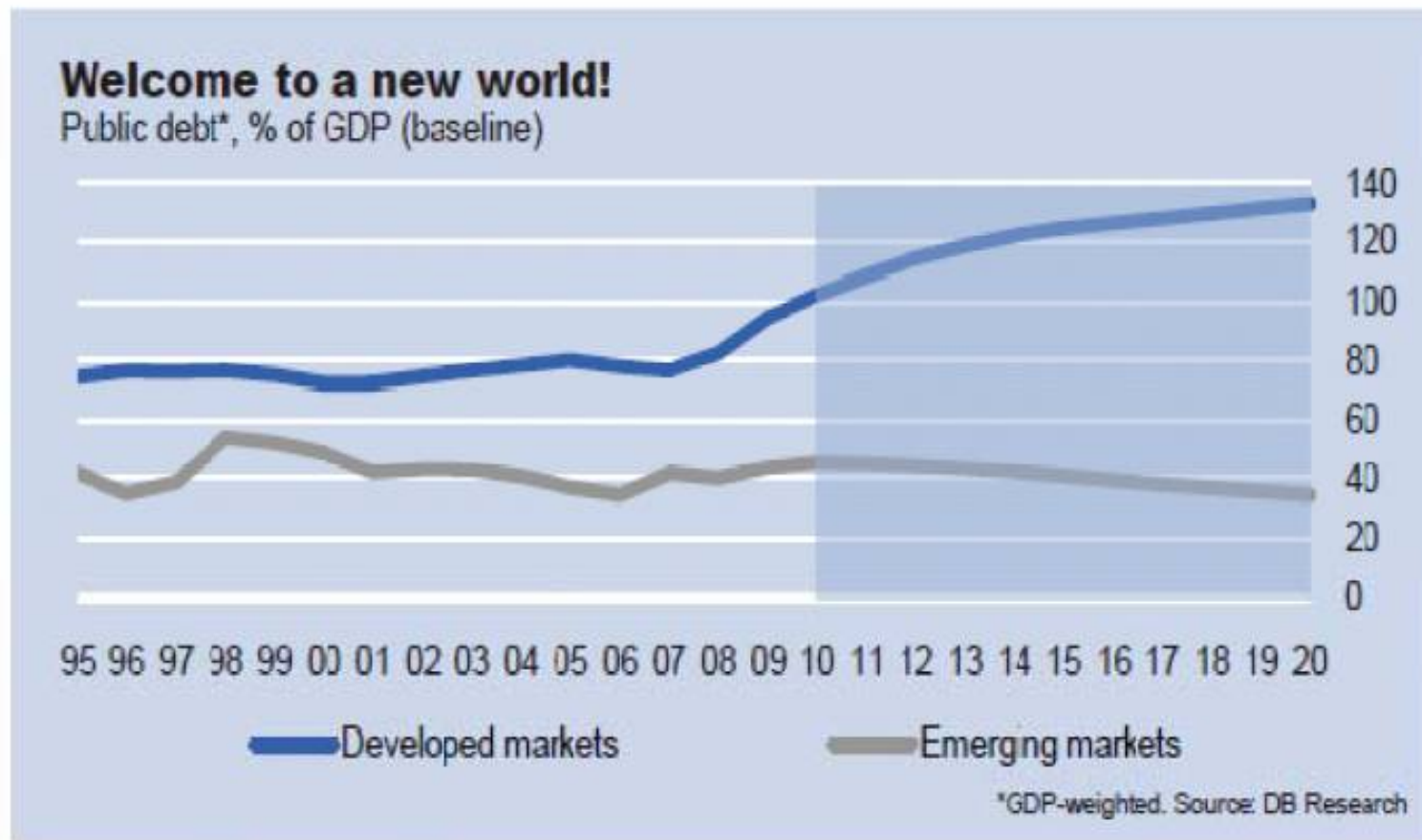
Source: OECD, DB Global Markets Research



EM countries face a much better 'fiscal future'

“Following financial crises real public debt up 86% after 3 years”

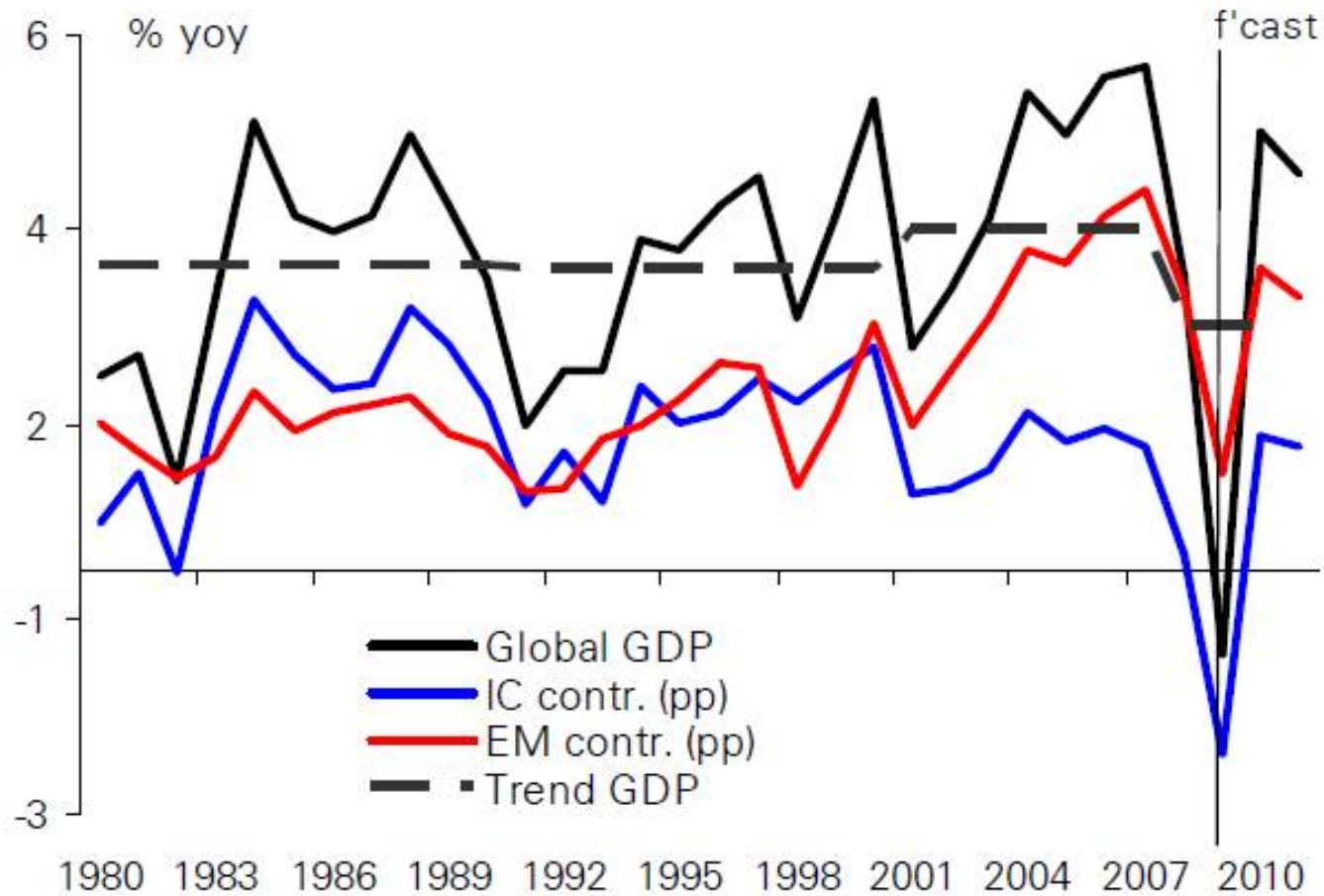
(Reinhart and Rogoff, “This time is different”, Princeton 2009)



Source: DB Research



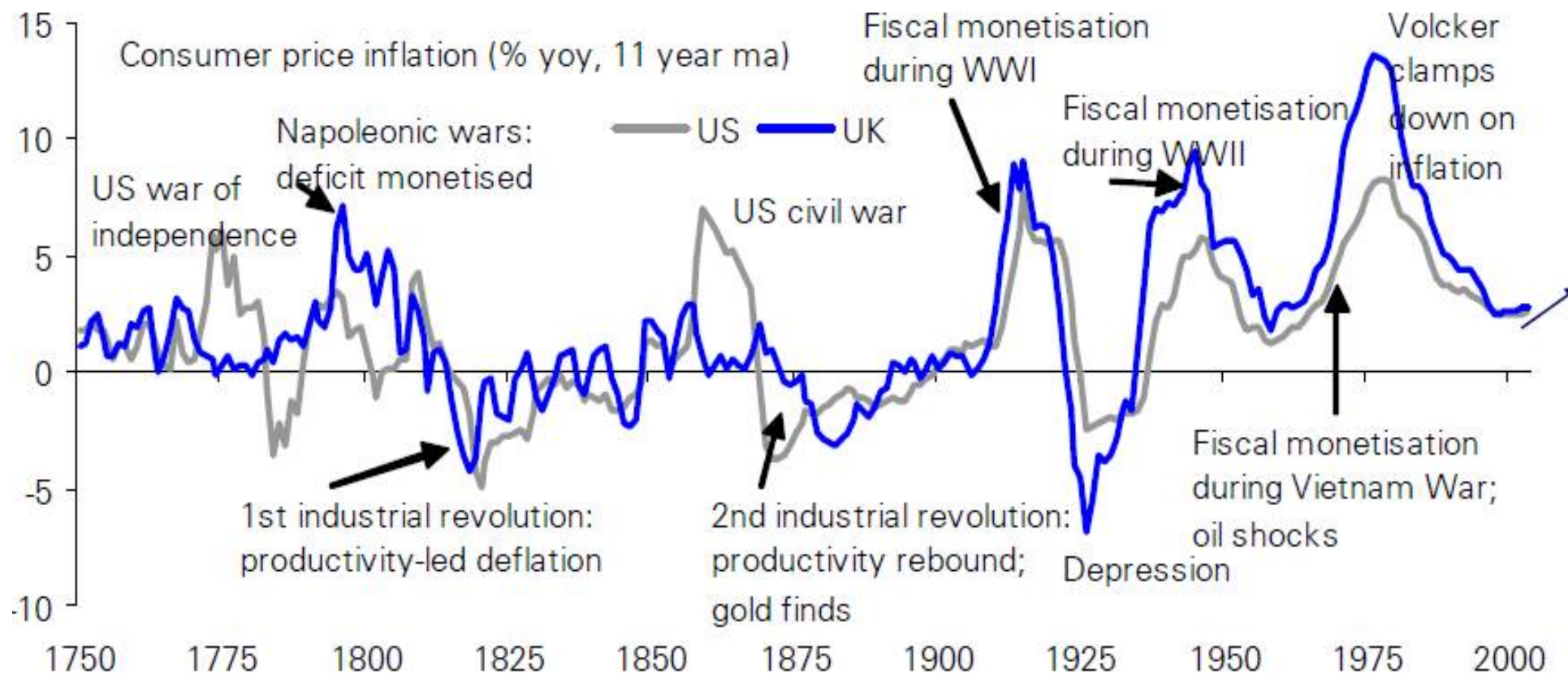
Lower global trend growth and different growth drivers in the future



Source: Deutsche Bank Global Markets Research



History points to monetisation of public debt and inflation



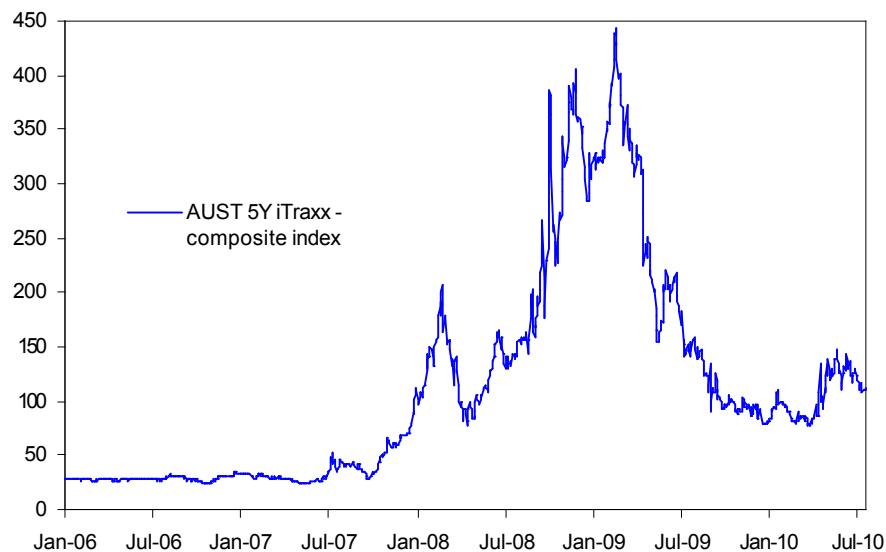
Source: DB Global Markets Research, Economic History Service



Credit will be both more expensive and harder to get

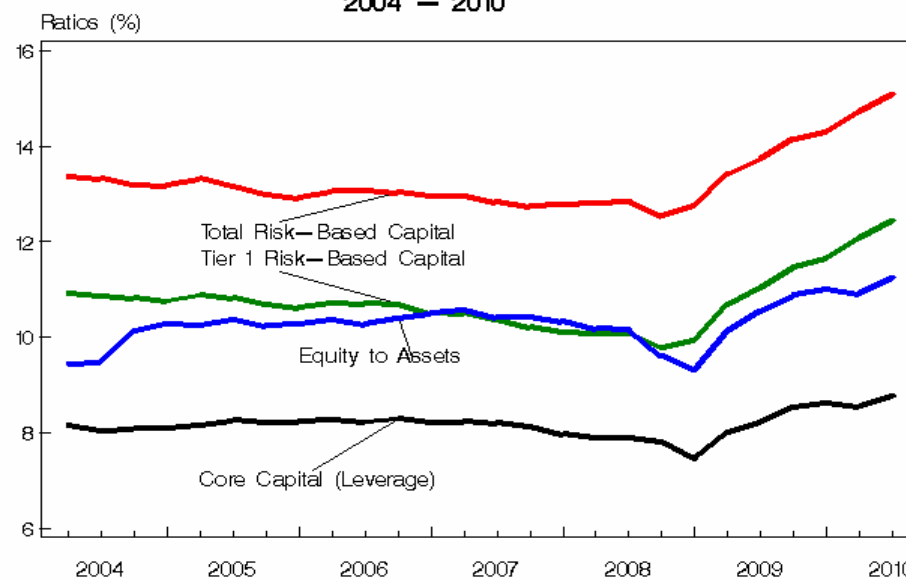
- Credit spreads have widened sharply from their pre-crisis levels.
- Regulators want to reduce the leverage in the banking system – by necessity this means credit will be less readily available.
- These changes are likely to be permanent.

Credit spreads have widened



Capital Ratios (All US banks)

2004 – 2010



Source: DB Global Markets Research, Reuters, FDIC

Meanwhile, Australia faces a different set of challenges

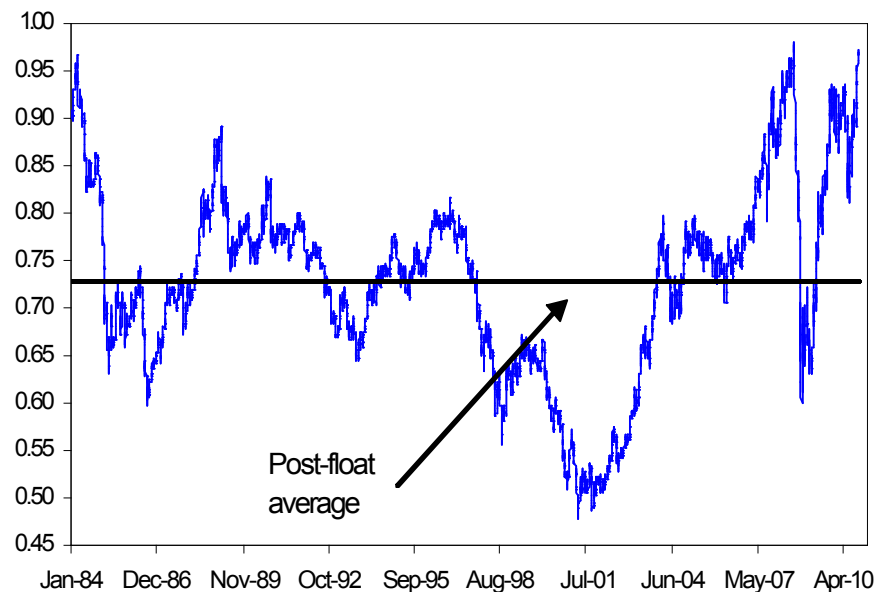


- The strong performance of the Australian economy has implications for our interest rates and the Aussie Dollar.
- In turn this has implications for different sectors of the economy.

The level of cash rates and housing finance



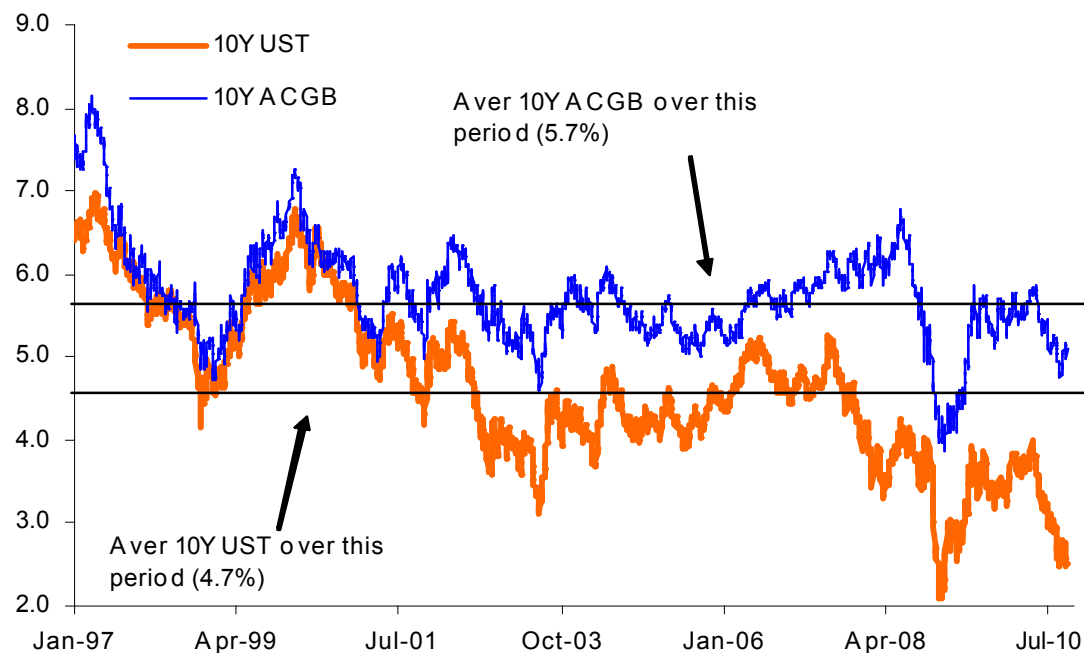
AUD/USD fx rate



Source: DB Global Markets Research, ABS, Bloomberg Finance LP



Note that our interest rates are close to 'normal' despite exceptionally low rates in the US – this could be a long term divergence

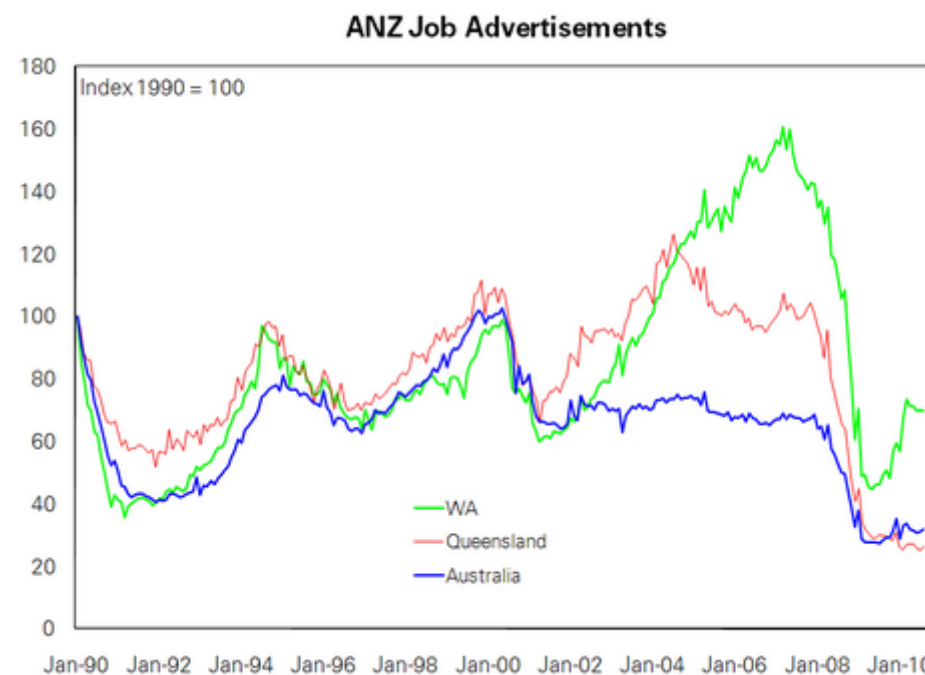
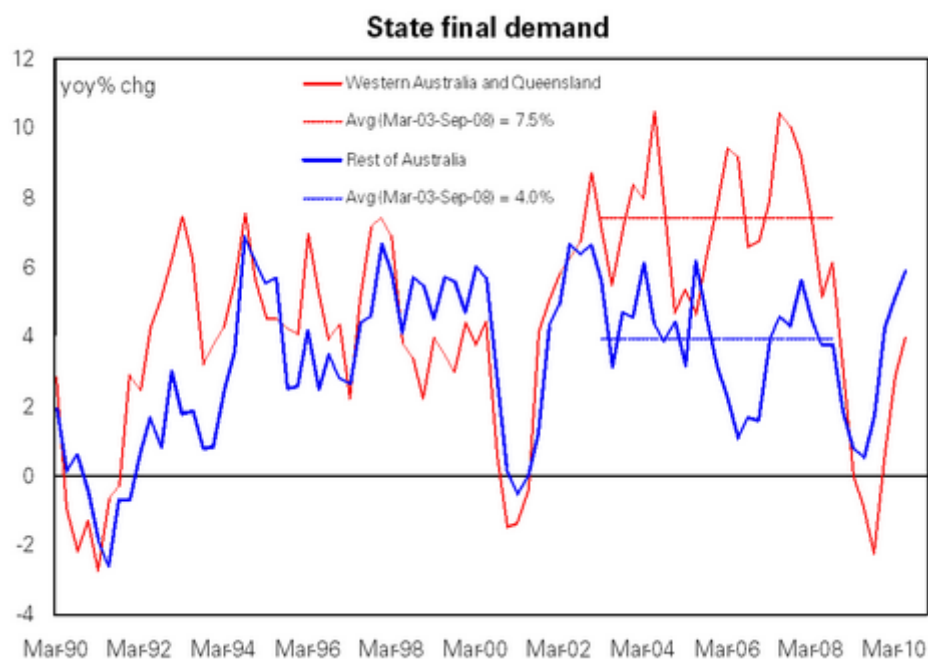


Source: DB Global Markets Research, Bloomberg Finance LP



There are regional implications from the set of economic circumstances facing Australia

- The resource rich states, WA and Queensland, outperformed during the commodity boom and then suffered the most during the global slump.
- They are now recovering rapidly, though the more diverse nature of the Queensland economy means it is lagging the pick-up seen in WA.



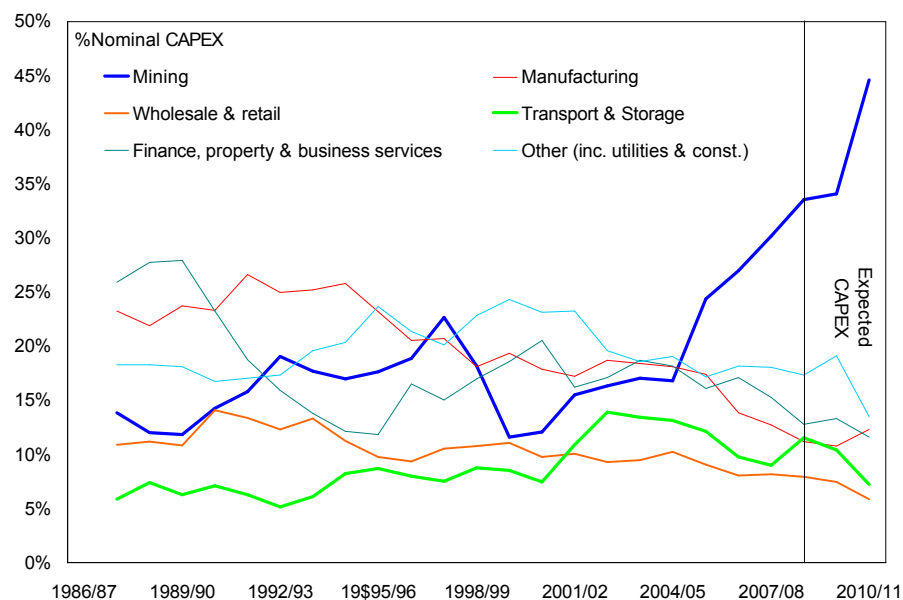
Source: DB Global Markets Research, ABS, ANZ



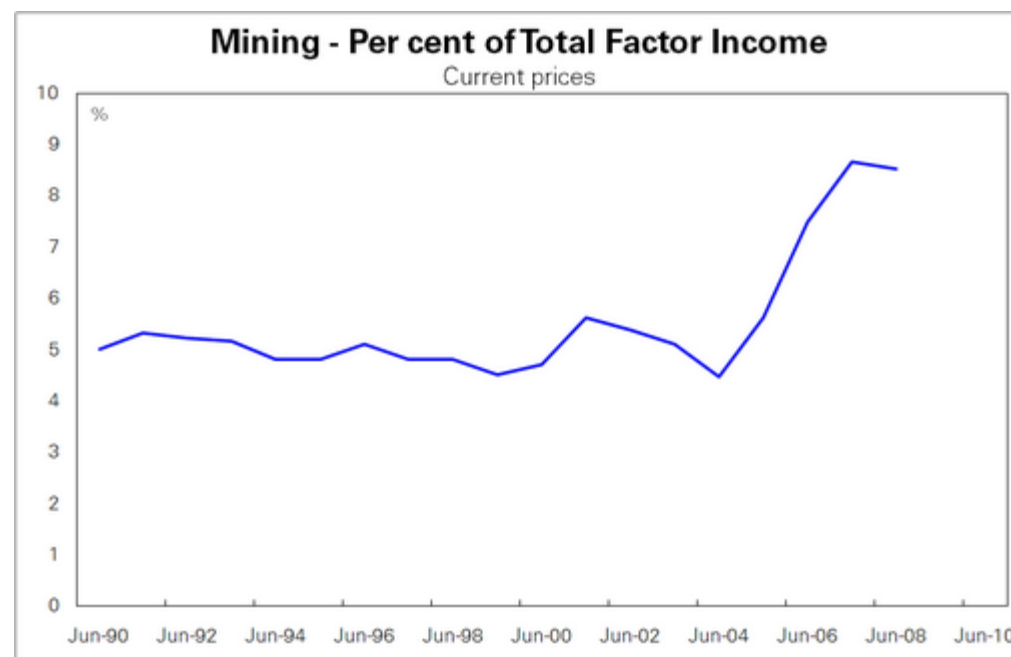
The growing exposure to mining will have implications for the volatility of the economy

- The share of the economy directly exposed to mining has grown over the past decade.
- Given the investment intentions of the mining sector its share will continue to grow.
- This means that Australia will become increasingly exposed to the volatility of commodity prices.

Mining dominating private sector CAPEX outlook



Mining - Per cent of Total Factor Income



Source: DB Global Markets Research, ABS, Bloomberg Finance LP



Longer-term conclusions: volatility likely to increase

- Countries with high debt levels face constraints on their policy choices.
- This will lessen their ability to respond to further shocks, suggesting that growth over the next decade could be a lot more volatile than over the past twenty years.
- Fortunately Australia's growth prospects are more highly linked with the low debt/high growth EM countries.
- While this is a plus, it has implications in terms of the likely interest rate and currency settings facing the Australian economy.
- In turn this has implications for the mix of economic growth in Australia – in terms of both sectoral and regional growth. Those parts of the economy exposed to interest rates and the currency are likely to be squeezed on a relative and absolute basis so long as the commodity boom continues.
- This means the commodity sectors will grow as a share of the economy, continuing the trend evident for a decade.
- This will have implications for the overall volatility of the economy and, in turn, for the volatility of fiscal and monetary policy settings.
- We need to prepare for downside surprises.



The Near-term Economic Outlook

Our economic forecasts by country/region



Economic Forecast Summary

	GDP growth, %				CPI inflation, %			
	2008	2009	2010F	2011F	2008	2009	2010F	2011F
G7	-0.2	-3.5	2.6	2.1	3.2	-0.1	1.3	1.4
--US	0.0	-2.6	2.8	3.1	3.8	-0.3	1.6	1.7
--Japan	-1.2	-5.2	2.7	0.1	1.4	-1.4	-0.8	-0.7
--Euroland	0.3	-4.0	1.5	1.0	3.3	0.3	1.6	1.7
EM Asia	7.1	5.7	8.8	7.3	6.9	0.9	4.5	4.0
--China	9.6	8.7	9.6	8.6	5.9	-0.4	3.0	2.5
--India	6.4	5.7	8.9	8.1	9.1	2.2	9.8	7.2
EMEA	4.4	-5.4	4.1	4.2	12.6	8.0	7.7	6.9
--Russia	5.6	-7.9	4.0	4.5	13.3	8.8	8.1	7.3
Latam	4.0	-2.6	5.5	4.1	9.5	6.0	7.9	7.7
--Brazil	5.1	-0.2	7.6	4.5	5.9	4.3	4.8	5.0
Ind. countries	0.0	-3.4	2.3	2.0	3.3	0.0	1.4	1.5
EM countries	6.0	2.3	7.3	6.1	7.9	2.8	5.3	4.9
Global	2.7	-0.9	4.5	3.8	5.3	1.2	3.1	3.0

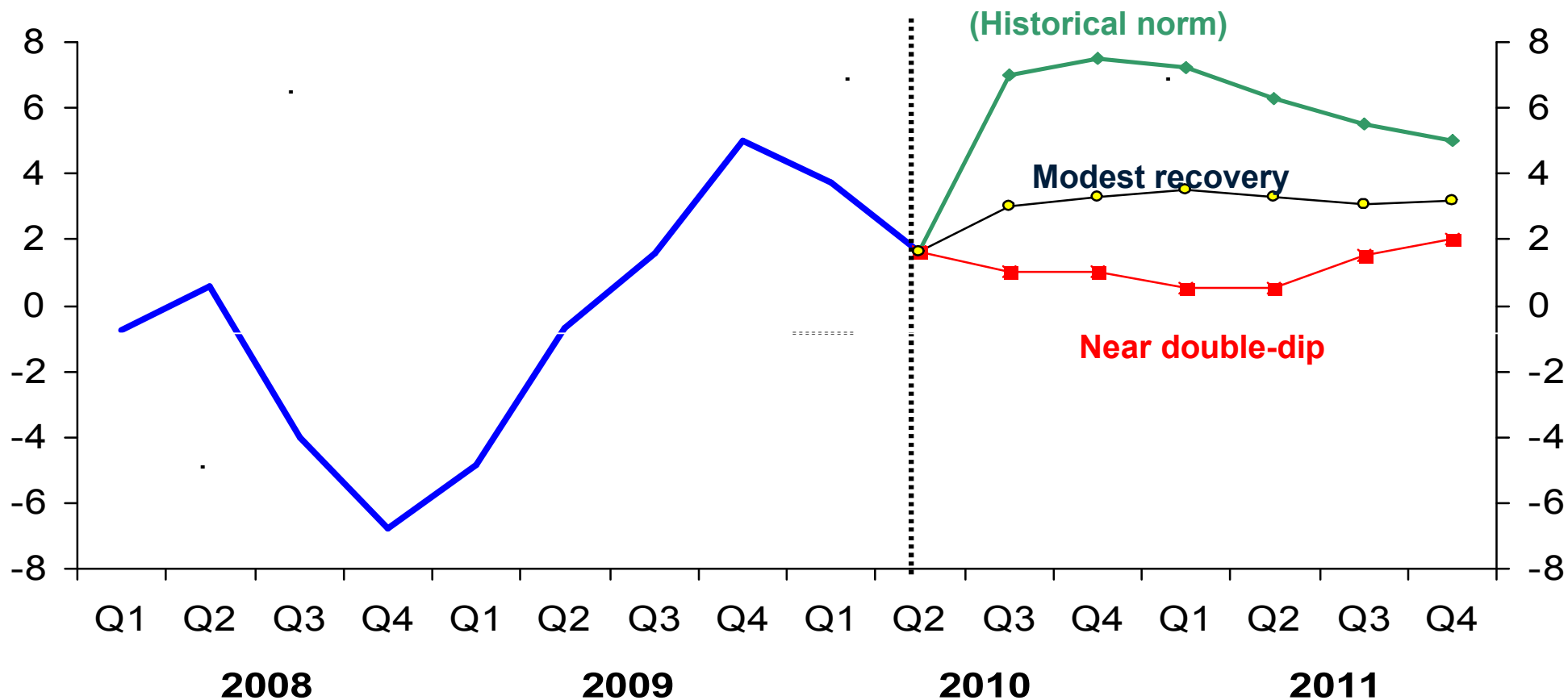
Source: Deutsche Bank Global Markets Research

A key issue: Might the US economy double-dip?



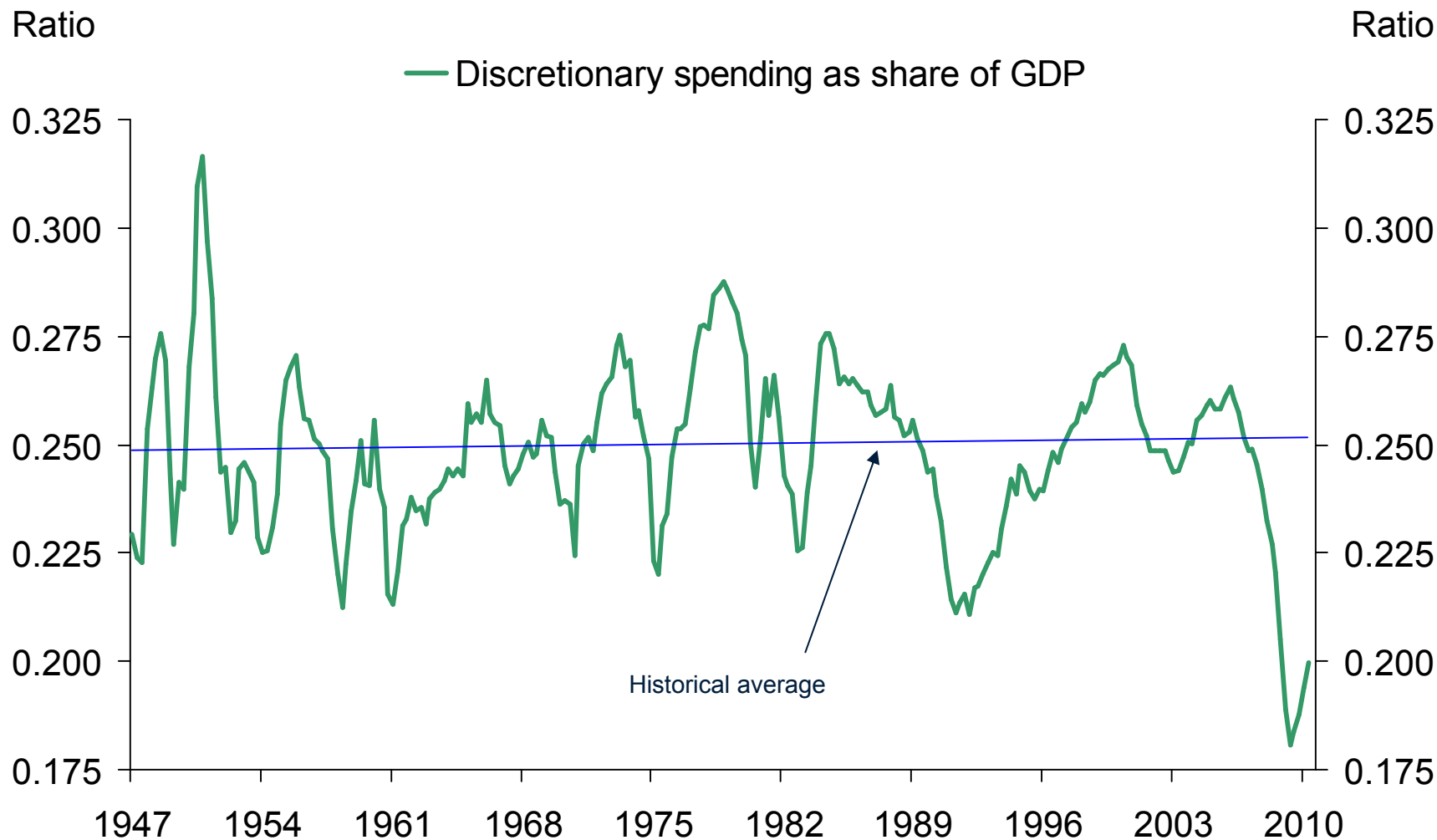
Q/Q%, AR

Q/Q%, AR



Source: DB Global Markets Research, BEA

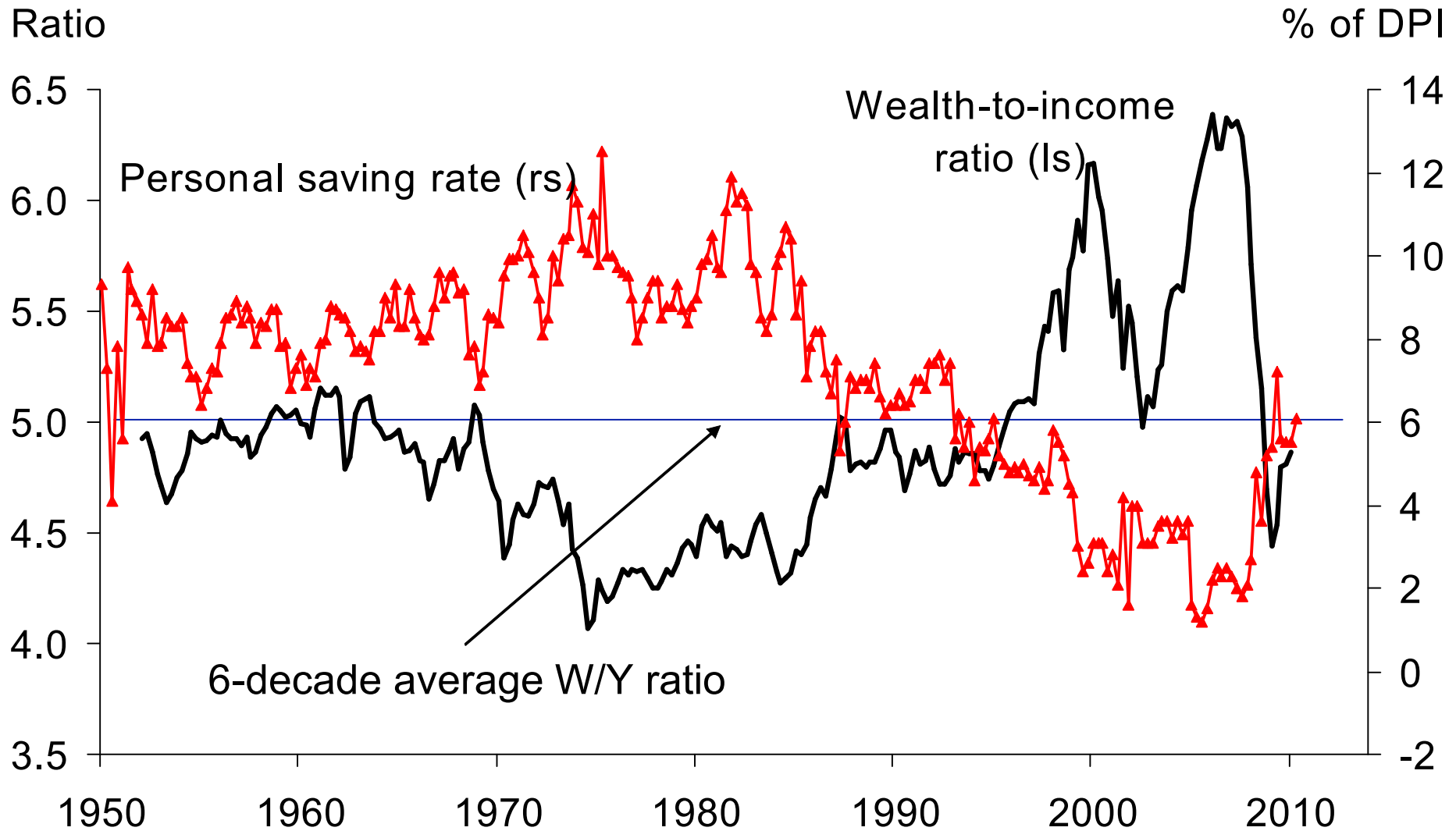
Key Driver: Pent-up US demand



* Discretionary spending here includes personal consumption expenditure on durable goods and gross domestic private investment.

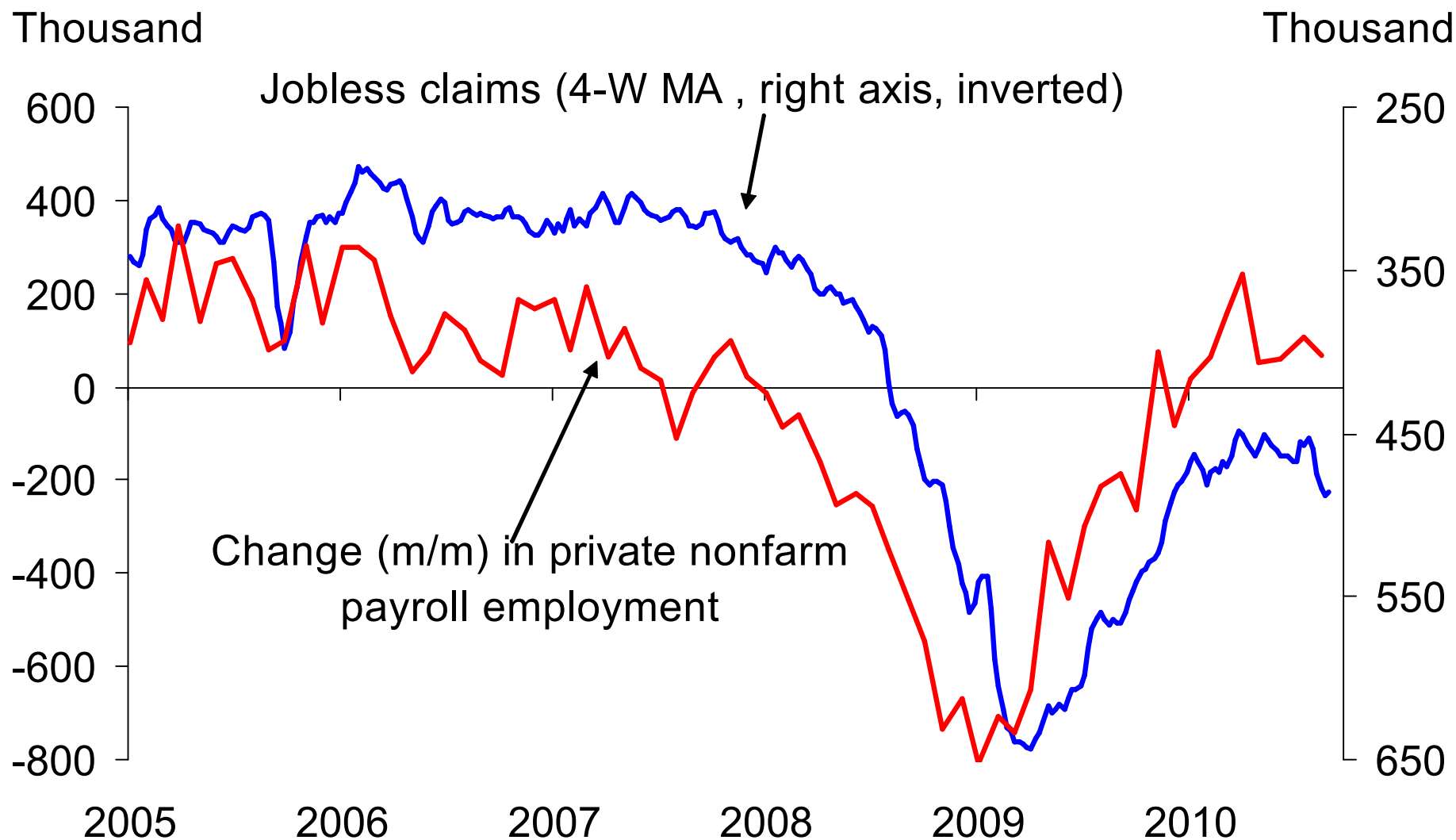
Source: BEA, DB Global Markets Research

US savings rate may not need to increase further with wealth back to historic average



Source: BEA, FRB, DB Global Markets Research

But US labour market remains a risk to the outlook



Source: DB Global Markets Research, BLS, DoL



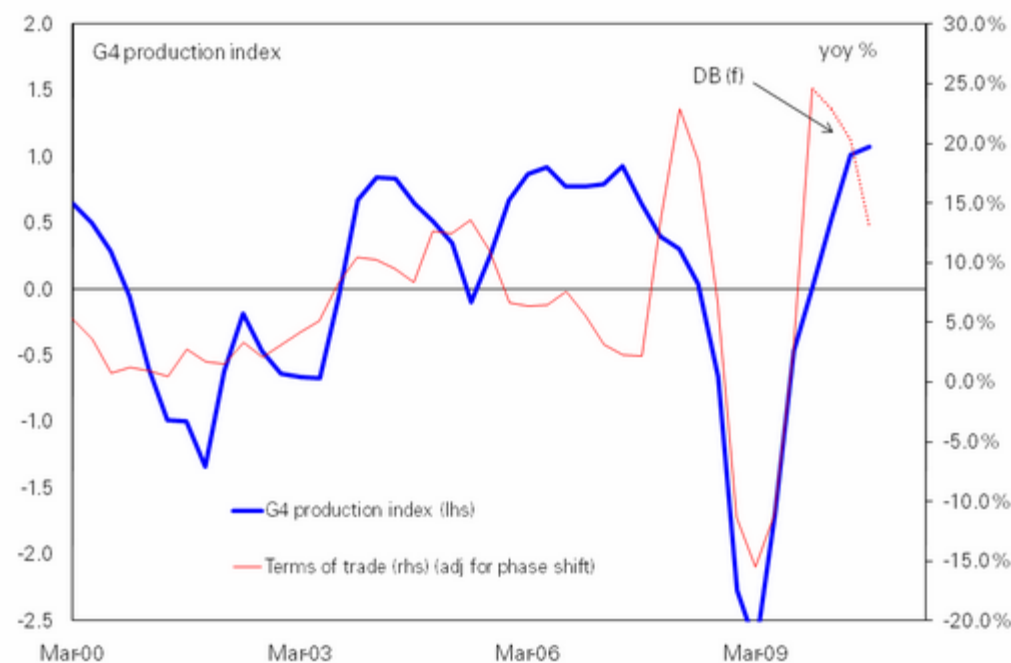
Australia benefits from being a 'caterer' to EM growth

- Australia's terms of trade has surged over the past year.
- With the gain consistent with the global recovery.

Australia's terms of trade



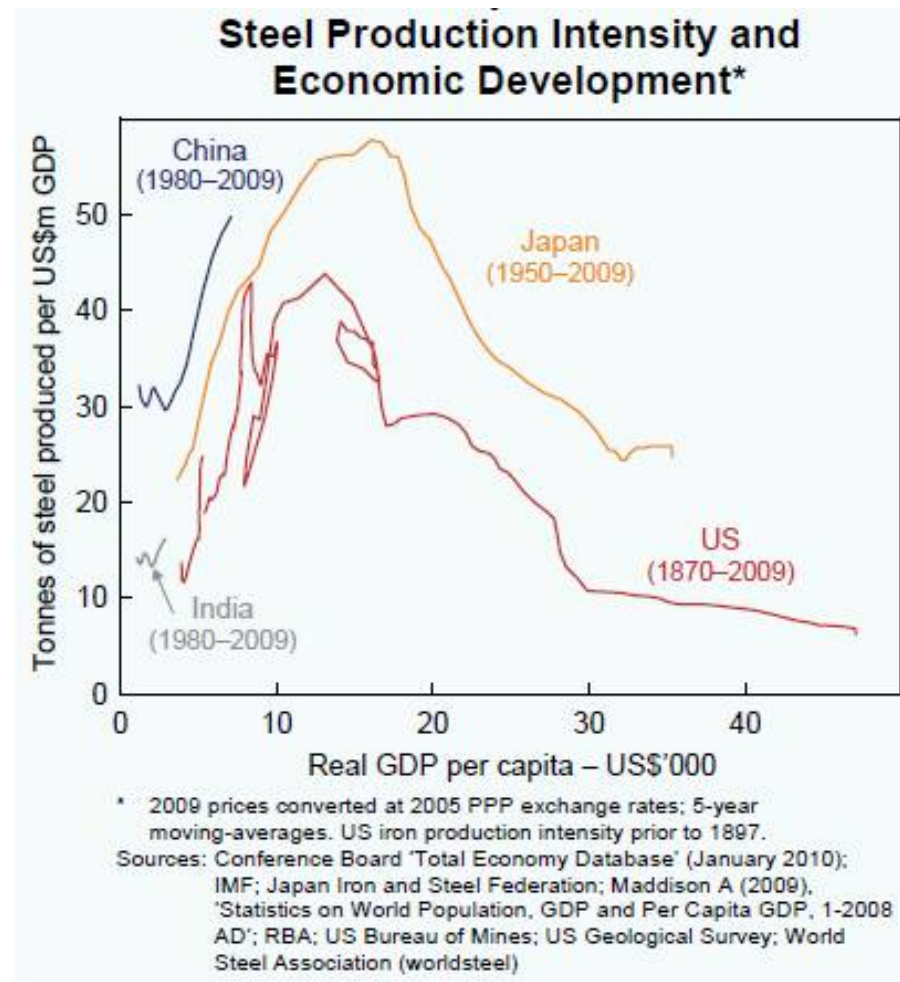
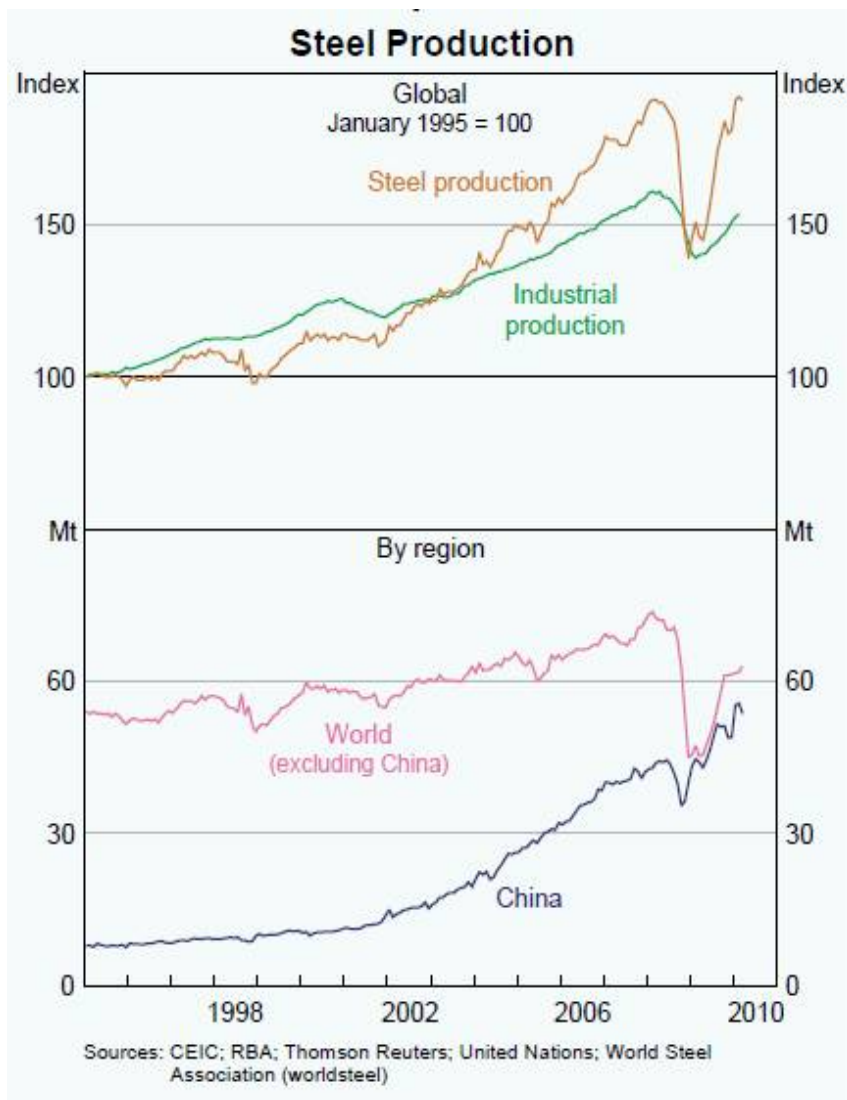
Global production and the Australian terms of trade



Source: Deutsche Bank AG, Datastream, Bloomberg Finance LP



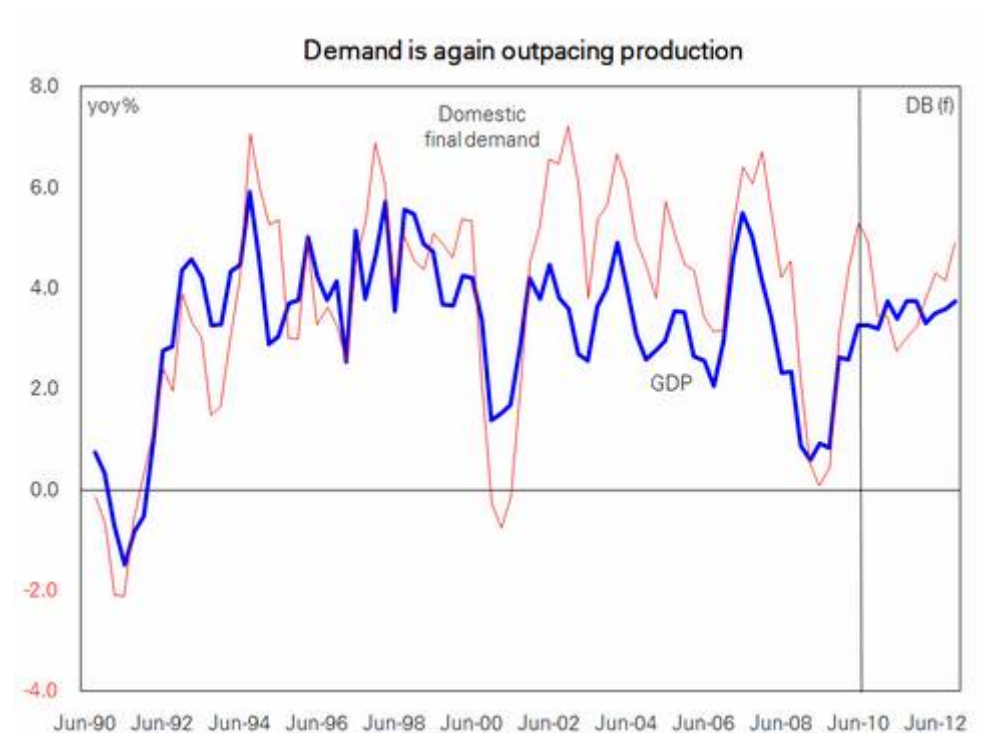
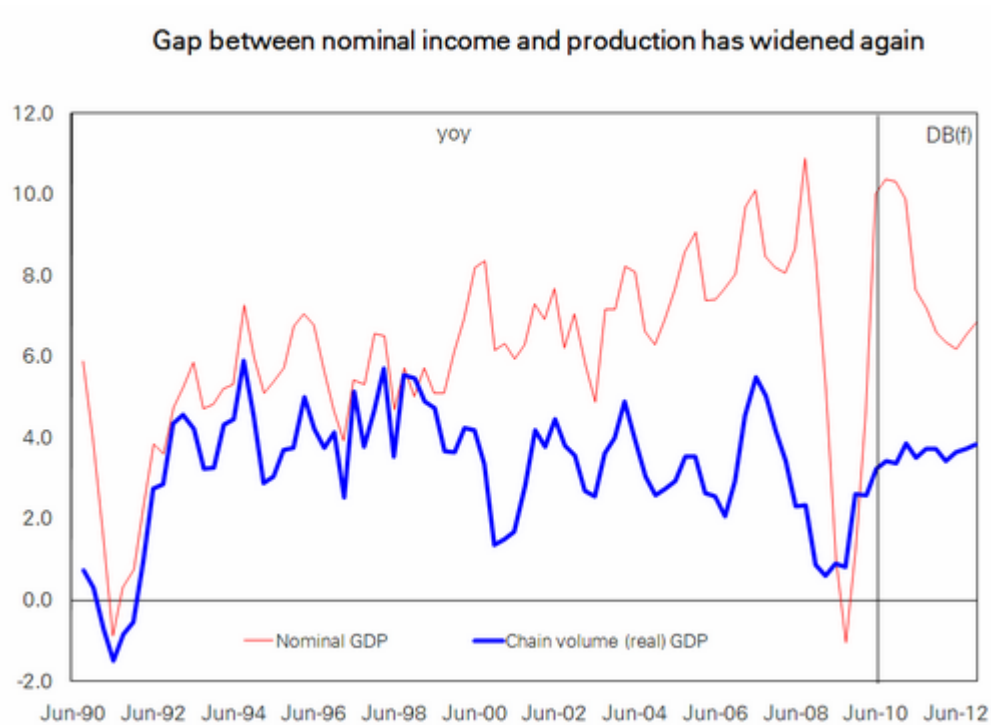
With China a big part of the story and the long-run picture remaining positive





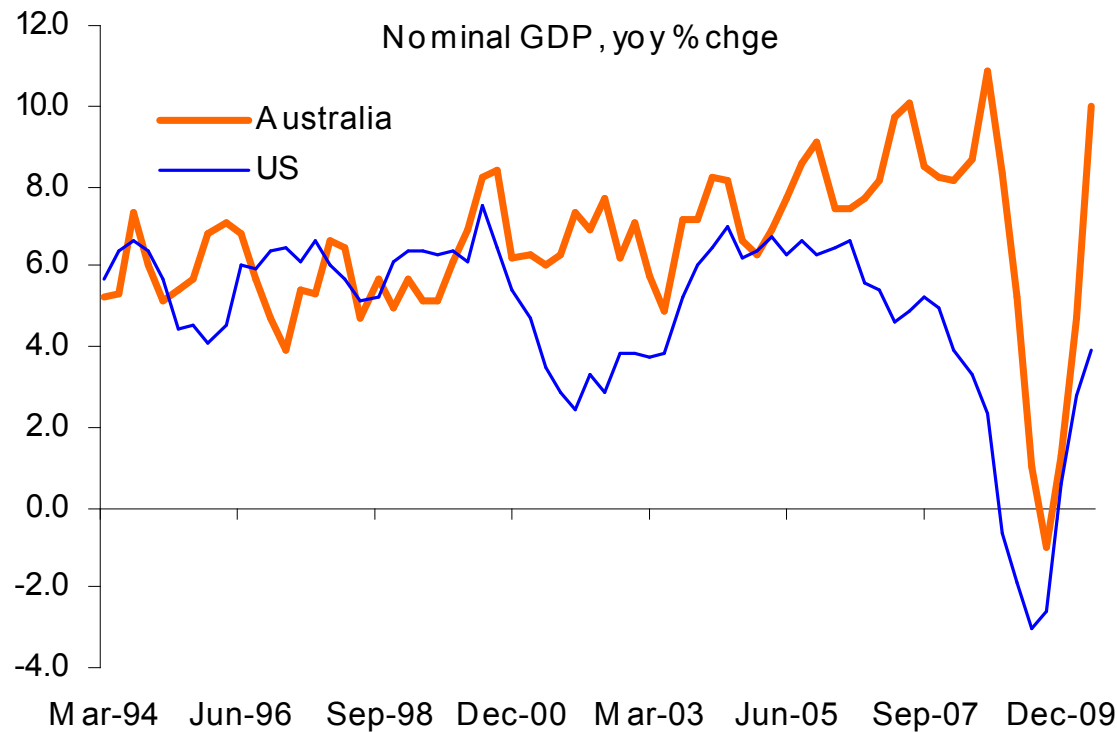
As a consequence of the rebound in the terms of trade Australia is back to managing 'success'

- Nominal GDP rose to 10% in year-ended terms in June 2010.
- This has seen domestic final demand once again move higher than (real) GDP growth.



Source: Deutsche Bank Global Markets Research, ABS

The contrast with the performance of the US economy is particularly stark

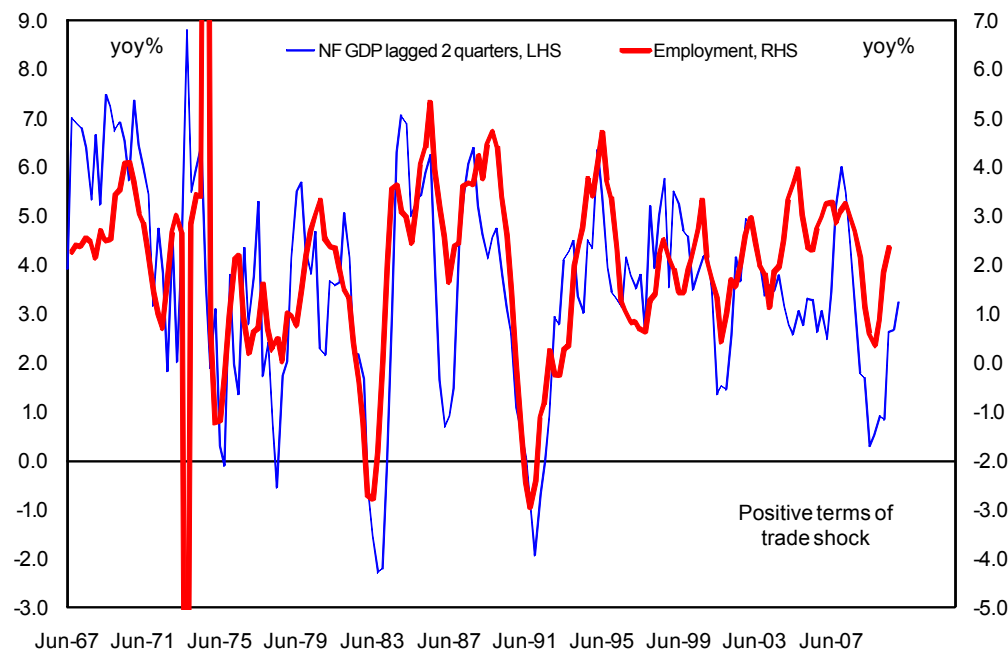


Source: Deutsche Bank Global Markets Research, Bloomberg Finance LP

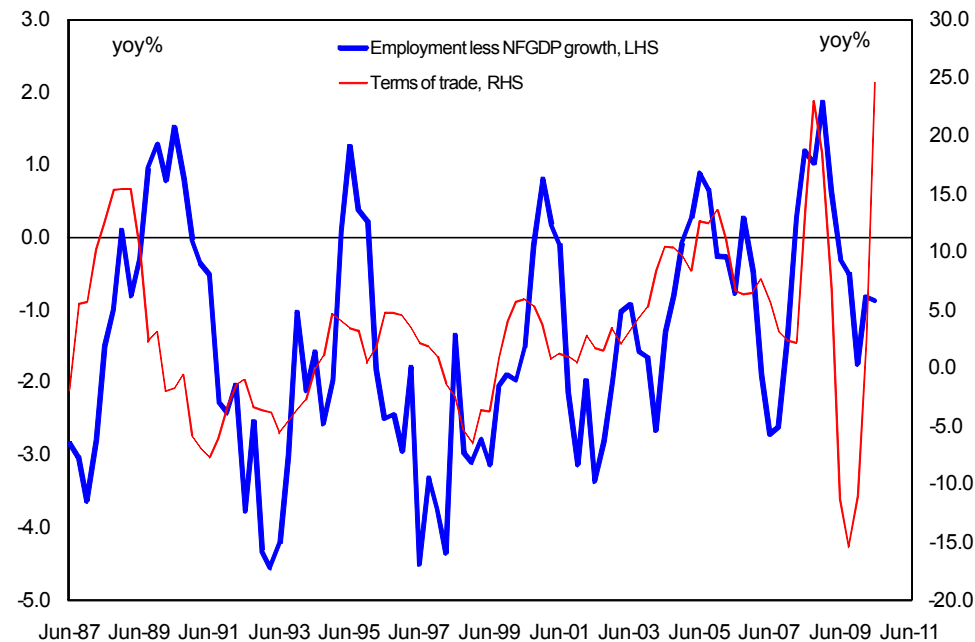
A terms of trade shock has widespread implications for the Australian economy



Non-farm GDP and employment growth



Rising TOT consistent with stronger employment growth



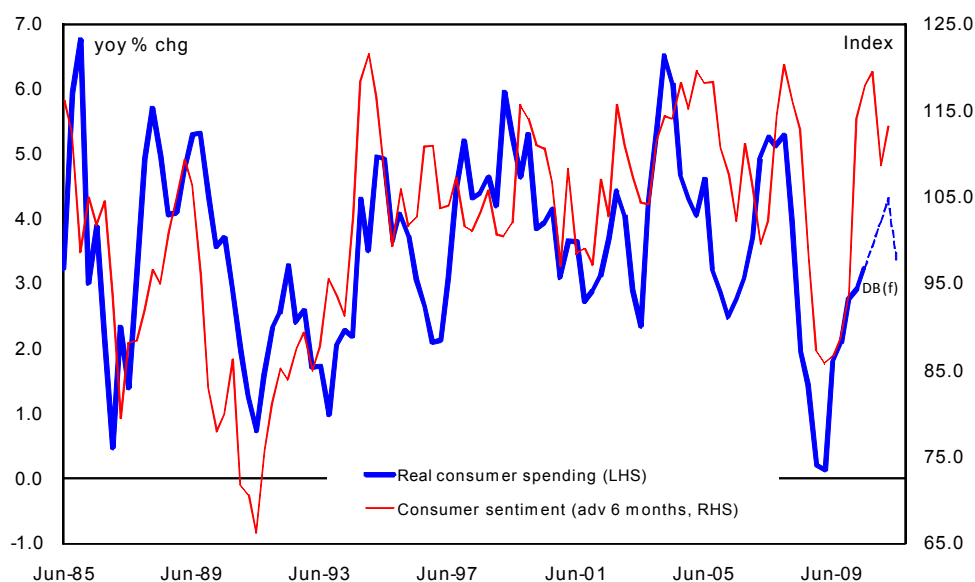
Source: Deutsche Bank Global Markets Research, ABS

A recently subdued consumer has started to resurface

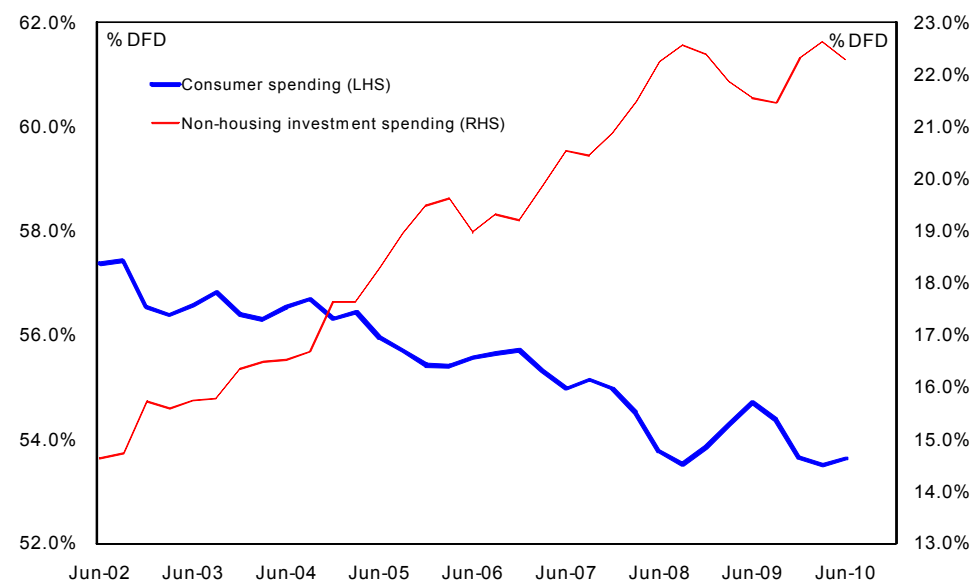


- While a modest pick-up in consumer demand would not ordinarily cause concern, a pick-up against a backdrop of high levels of consumer confidence, limited slack and a very strong outlook for business investment is problematic.
- It is simply not possible for every sector of the economy to grow above trend.

Consumer sentiment and spending



Domestic Final Demand - Two Speed Economy



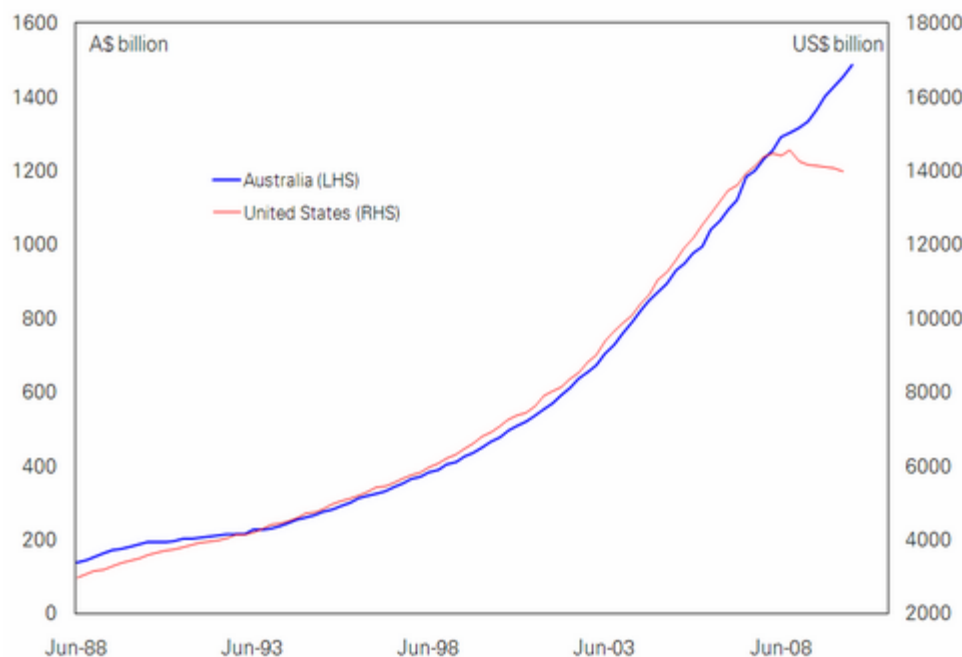
Source: Deutsche Bank Global Markets Research, ABS



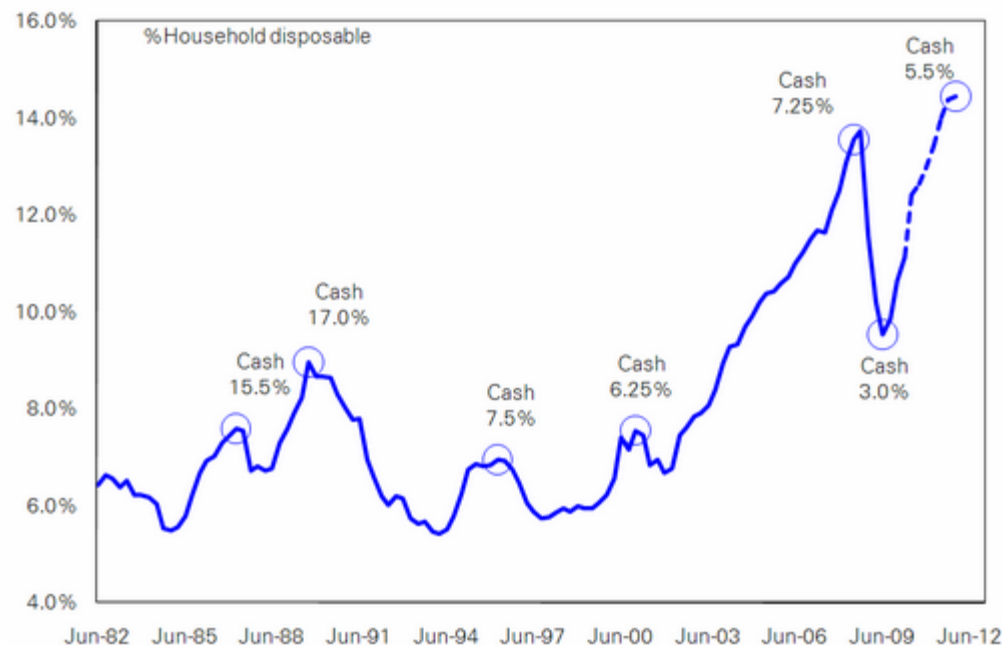
The high level of household debt in Australia is a consideration for the interest rate outlook

- One of the reasons that Australia did well during the global financial crisis is that households continued to take on debt.
- This increases the sensitivity of households to interest rates and is one of the reasons we don't expect the cash rate peak to be as high as in 2008 (unless the commodity prices continue to rise for a few more years).

Financial Liabilities of the AUS and U.S. Household Sectors



Household debt service ratio



Source: Deutsche Bank Global Markets Research, ABS, RBA, Fed



Appendix 1

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